

UK Economic Forecast Report

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Uncertainty Lies Behind Forecasts for UK Economy

Introduction

Most independent economists¹ are forecasting a 3% to 4% contraction in the UK economy, continued negative RPI growth and low bank base rate levels for 2009. Looking back a year or more ago, most economists failed to predict the severity of the current downturn. Forecasters are now looking forward to how the recovery may turn out, and there is a risk that the consensus economic outlook for the next few years may again prove unreliable.

There have been some changes to the range of medium term forecasts by independent economists over the past six months published by HM Treasury, although most point towards a gradual recovery. That said, it is generally accepted that there remains a wide range of potential outcomes that could occur over the next few years, and the risk of outcomes outside of the consensus range is relatively high. This uncertainty serves only to make business planning increasingly difficult.

Underpinning the platform for recovery are the huge government deficits that appear to have successfully stimulated the economy to a certain degree. Furthermore, it also appears that confidence has been returning to the banking sector, again underpinned by government support. This confidence has been reflected in the interbank lending rates (LIBOR), which have been falling throughout 2009.

¹ Independent economists include a selection of academic, not for profit, and private sector forecasting organisations that are independent from the views and forecasts of HM Treasury. Their inclusion on a list of independent forecasters is subject to review and no significance should be attached to the inclusion or exclusion of any particular forecasting organisation.

Nevertheless, despite the apparent economic benefits of government action to date, it is not clear whether or not current and proposed action may actually impede economic growth once the recovery takes place. Indeed it may be the case that recent Government action is only masking systemic economic problems that are a reflection of the structure of the UK economy, in particular over exposure to the financial sector and housing market, and the high levels of indebtedness. If these issues are not adequately addressed and are being stored up, then at some stage in the future they will need to work through the system.

UK Economic Outlook

After suffering a severe contraction in the first part of 2009, most independent economists are forecasting that the UK economy will move out of recession in 2010 if not before the end of 2009. That said, growth is expected to be relatively modest, with a gradual increases in growth before returning to levels of around 2% to 3% towards the end of the forecast period in 2013.

A measured recovery with gently increasing levels of inflation and costs of borrowing back to the steady levels the economy enjoyed before the recession, navigates a way between much higher inflationary and deflationary scenarios. The probability of high inflation or deflationary scenarios occurring may not, however, be an insignificant risk. It may be worth considering the fact that low and stable inflation and interest rates, which have characterised the past decade or so, were not always the case further back in economic history.

Historically a severe recession is typically followed by a strong recovery. It is not clear whether the UK has already reached a definite turning point in the economic cycle, or is about to reach it. If the UK has already reached this turning point then it is possible that a recovery could occur relatively quickly. This is part may be a function of the strength of the policy response of government to counter-act the severity of the recession. It may also be in part due to the ability of firms to quickly re-build their levels of inventory as recovery takes place, in the same way that they were able to quickly run down their stocks in the face of recession. Recent increases in commodity prices may point to the beginning of a global recovery. Whether these events will create sustained inflationary pressures in the future is yet to be seen.

An inflationary period would reduce the relative burden of existing levels of debt on businesses and households, but it would also impact the purchasing power of consumers and the level of investment. Furthermore inflation would increase bond yields and put up the cost of government borrowing. Higher interest rates are likely to jeopardise future economic growth and could lead to another recession or a period of stagflation that may last for some time.

In the shorter term, however, deflationary pressures remain a major concern. A deflationary environment, encouraged by falling house prices and mortgage repayments, a downward pressure on energy and commodity prices, and the working through of falls in production costs to consumers, would dampen any government stimulated recovery.

The recession was caused by failures in the global financial system, and government efforts to stabilise the situation appear to have been successful with confidence returning to the financial world. That said, some of the fundamental imbalances in the wider economy remain and there is a serious risk that there may be greater than expected losses in the financial sector as a consequence

of increased corporate and personal bankruptcies over the next year or so. Inability to refinance highly leveraged investments that were funded at the height of the boom period and become due over the next twelve to eighteen months may further crystallise bank losses. If these potential losses serve to undermine confidence between lending banks, then it is possible that LIBOR rates will drift upwards again.

Furthermore, businesses and households in general remain over-leveraged, and may choose to pay down their debts rather than invest or consume for a considerable period of time. Reductions in government spending levels are also likely to act as a constraint on growth in the future, and given the perilous state of public finances and the risk to the UK's AAA credit rating it is difficult to see how government can continue its high level of spending for any significant period of time. If a combination of these factors creates deflationary pressures, then a period of low demand may persist for some time.

Forecasting the Shape of Recovery

Very modest levels of growth forecast by independent economists for 2010 and 2011 suggest there may well remain spare capacity in the economy and high levels of unemployment may persist throughout a recovery. The general consensus among independent economists appears to suggest a slow recovery, with growth only returning to its pre-recession levels after several years.

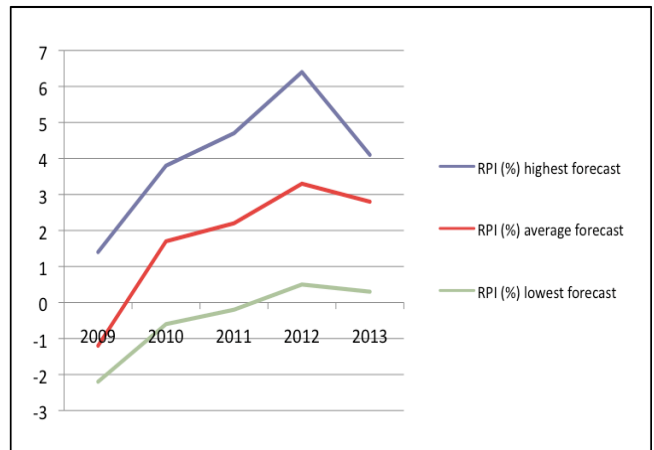
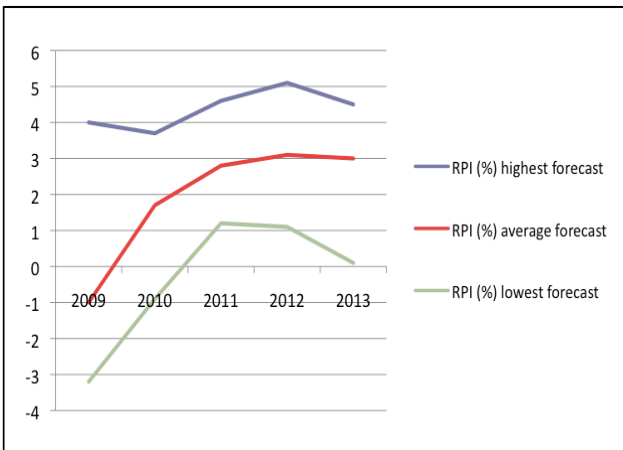
Different scenarios outside the consensus range are worth considering for business-planning purposes, including an extended deflationary period as well as a relatively quick recovery characterised by rapid growth in inflation. While the economy may appear to be moving out of recession, a combination of growing unemployment, increasing interest rates, tax rises and spending cuts may make the recovery far from straightforward. On the other hand, further stimulation by government may risk higher inflation if a full recovery is already underway.

The graphs shown below are taken from "Forecasts for the UK Economy – A Comparison of Independent Forecasters", published by HM Treasury in February 2009 and August 2009. The forecasts include medium term forecasts to 2013. The graphs show the average forecast for key economic indicators across the group of independent forecasters, as well as the range between the most optimistic and most pessimistic individual forecast. The graphs also track the changes made by forecasters to key economic indicators between February 2009 and August 2009.

Over a six-month period between February 2009 and August 2009, forecasts for the current year (2009) have followed a noticeable downward trend in response to worsening economic data. However, forecasters expect improvements in economic performance in 2010 and beyond, although the speed of recovery has been reduced given the unexpected severity of the recession. Most forecasters expect the UK to be out of recession by 2010, and the trends do not appear to show the UK falling back into recession once the recovery has started.

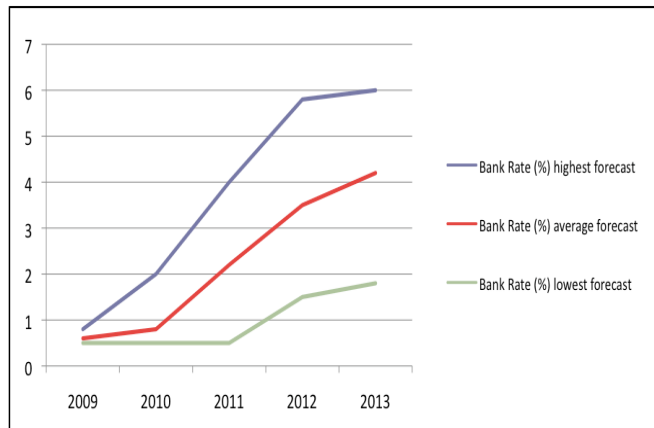
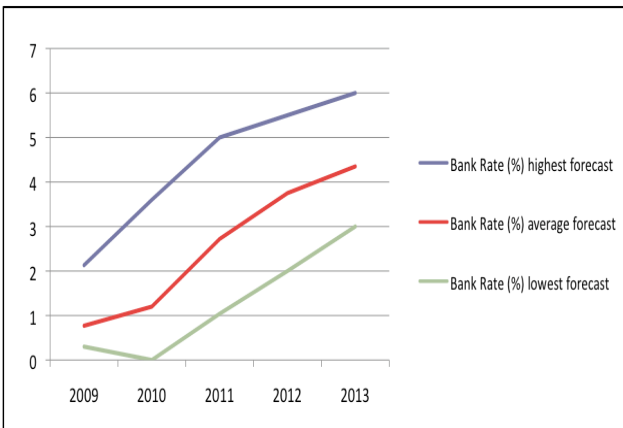
The highest RPI level towards the end of the forecasting period is about 6%, and the highest bank base rate levels are also expected to be about 6%. On average forecasters expect RPI to increase to about 3% (from the current level of -1.3%), and bank base rates to increase to about 4% (from the current level of 0.5%). In the same way that forecasts for 2009 have been adjusted downwards, forecasters are likely to revise their forecasts in response to unexpected economic data. The reliability of the forecasts over a five-year period cannot be certain, and businesses planners would be wise to consider other scenarios outside the forecast range.

Independent Economists' Forecast Changes in % RPI - February 2009 & August 2009



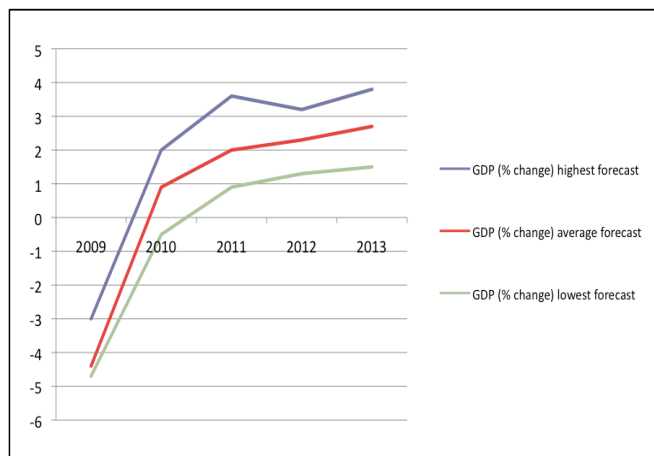
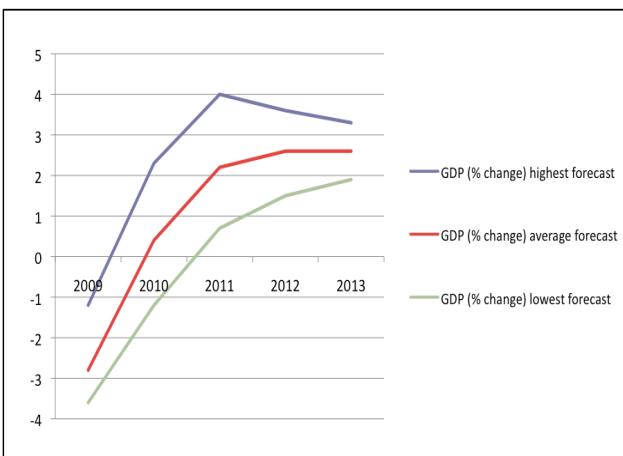
Source: HM Treasury

Independent Economists' Forecast Change in Bank Rate - February 2009 & August 2009



Source: HM Treasury

Independent Economists' Forecast Change in GDP - February 2009 & August 2009



Source: HM Treasury

Case Study

Economic Uncertainty and Housing Association Business Planning

Economic uncertainty brings with it both opportunities and risks. Well managed housing associations with robust cash flows and a degree of financial flexibility over and above committed expenditure levels, may be able to take advantage of lower development and acquisition costs. On the other hand RSLs that are less financially strong and do not adequately size potential risks and take action to mitigate these risks, may come under financial pressure and may not necessarily be able to rely on future Government bail-outs.

The uncertainty in all of the key economic indicators reflected in the report above will have a direct impact individual housing associations business plans over the forthcoming years. In particular it seems that the current negative RPI level will be reflected in lower rent setting next year. Although most forecasters are predicting that the UK will move away from negative RPI levels next year, inflation is forecast to remain relatively low over the following four years. On average forecasters are expecting RPI to be at around 2% for this period. More pessimistic forecasters are predicting RPI to be closer to zero, a level that is below typical inflation assumptions that underpin many RSL business plans.

Inflationary considerations have a relationship to interest rates. Interest rate risk has been typically managed by RSLs by having the majority of debt fixed or hedged, and as a consequence only a relatively small proportion of debt service charges reflect the current RPI and low base rate environment. Furthermore, fixed rate debt is serviced by net cash flow from rents, and this cash flow will be affected by rents being linked to RPI.

RPI assumptions are key to RSL business planning, and the range of appropriate RPI stress assumptions depends on the financial status of the RSL and its development ambitions. In the first instance, assumptions around RPI can impact financial viability, particularly those RSLs generating little or no surplus. For RSLs with development ambitions, inflation assumptions will underpin the capacity to develop, although assumptions around the costs of development and the availability of grant funding will also impact development plans.

In a period of economic uncertainty, the probability of more extreme levels of inflation or deflation occurring is increased. RSLs may need to think more creatively about managing RPI risk. As far as possible RSLs should seek to adjust their expenditures to mirror any changes to revenues, and out-sourcing areas of work should help increase financial flexibility. RSLs may also seek to share some of the risk of unexpected changes to inflation by linking interest payments to changes to RPI that affect rental income. This would provide added certainty in the future with regard to the existing capacity for development and would protect against changes in inflation changes this capacity. On the other hand, the potential for future increased capacity if inflation moved in a favourable direction would be reduced.

RSLs will need to take a more pro-active view of wider economic trends and manage their particular business models accordingly. Clear strategic planning and decision-making is now more important than ever. RSLs should expect the unexpected, and should be innovative in their approach to managing risk.

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